80-2187

No. _____

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

MARGARET E. JOHNSON MALMSTEDT and Estate of BERTIL MALMSTEDT, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Writ Of Certiorari Re: United States Court Of Appeals For The Fourth Circuit

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PETITION FOR WRIT OF CERTIORARI

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Petitioners, MARGARET E. JOHNSON, MALMSTEDT and the ESTATE OF BERTIL MALMSTEDT, petition this Honorable Court for a writ of Certiorari:

QUESTIONS PRESENTED

1. Whether a taxpayer can be denied his right to use his tax returns as *prima facie* evidence and have them declared invalid by the courts below without challenge or audit by the Commissioner of such tax returns.

2. Whether the courts have the right to deny the taxpayer the use of a determined loss as a carry-forward pursuant to the provisions of Section 172 of the Internal Revenue Code, as amended (26 U.S.C. 172).

3. Whether tax returns, stipulated into evidence upon the motion of the Commissioner and never challenged by the Commissioner, prove the income of taxpayers in the years for which they were filed.

PARTIES TO PROCEEDING IN COURT WHOSE JUDGMENT REVIEW IS SOUGHT.

The caption of this case contains the names of all parties to the proceeding in the United States Court of Appeals for the Fourth Circuit whose judgment is sought by this petition to be reviewed.

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v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Writ Of Certiorari Re: United States Court Of Appeals For The Fourth Circuit

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PETITION FOR WRIT OF CERTIORARI

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1. OFFICIAL AND UNOFFICIAL REPORTS OF OPINIONS DELIVERED IN THE COURTS BELOW:[1]

Margaret E. Johnson Malmstedt, 38 TCM 903;

Margaret E. Johnson Malmstedt and Estate of Bertil Malmstedt v. *Commissioner of Internal Revenue*, unpublished decision, U.S. Court of Appeals for the Fourth Circuit, decided March 26, 1981, Dockets Nos. 79-1807 and 79-1808.

2. GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED.

The grounds on which this Court has jurisdiction are set forth in 28 U.S.C. 1254(1). Petitioners seek such review with respect to the unpublished decision of the U.S. Court of Appeals for the Fourth Circuit, dated March 26, 1981.

3. STATUTES INVOLVED.

This case involves the provisions of 26 U.S.C. Section 172, (a provision of the Internal Revenue Code of 1954, as amended), dealing with net operating loss carryforward deductions. The provisions of such section are set forth in the Appendix hereto.

4. STATEMENT OF FACTS OF CASE.

In January of 1960, Petitioners acquired a property known as the "Gold Mine", a one hundred thirty-eight (138) acre tract of land, and thereafter expended full time efforts on the development of the venture. There

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[1] Prior decisions involving the Petitioners, not related to the question here presented, are reported at 35 TCM 199 and 578 F. 2d 520; 78-2 U.S.T.C. 9479.

ensued numerous activities over the years, 1960, 1961, 1962, 1963 and 1964, which formed the basis for the May 26, 1978, Fourth Circuit Court of Appeals determination that the activity of petitioners was a trade or business qualifying for net operating loss deduction. The Gold Mine property ultimately went to foreclosure in March, 1964.

By its May 26, 1978, opinion, the U.S. Court of Appeals for the Fourth Circuit remanded the matter to the U.S. Tax Court for recomputation, stating:

> "***. It follows that there must be a recomputation of the taxpayer's tax liability, if any, after giving effect to the changes required under our ruling on the deductibility of interest and tax payments and the treatment of the unamortized portion of the refinancing fee. The allocation of such deduction among the tax years involved and right of carryforward of any such deductions are matters that can only be resolved on remand."

In its Memorandum *Sur Order* dated April 10, 1979, the U.S. Tax Court held that the only evidence offered by petitioners to sustain their claim for net operating loss carry-over as a result of the operations of the Gold Mine were their own income tax returns for the taxable years 1959 through 1965. It further stated it had grave doubt with respect to the accuracy of such returns because of the corrections that the court had made to the tax returns filed by the petitioners for other years. Petitioners appealed the finding of the U.S. Tax Court of Appeals for the Fourth Circuit, and on March 26, 1981, the U.S. Court of Appeals for the Fourth Circuit sustained the position of the U.S. Tax Court, stating:

> "***. The only evidence on these points was the taxpayers' income returns for tax years 1959 through 1965, which the court deemed insufficient

> largely because of the demonstrated inaccuracy of other returns filed by the taxpayers."

The U.S. Court of Appeals for the Fourth Circuit further stated:

> "Nor do we believe that this Court's prior determination that certain expenses were deductible foreclosed inquiry into the matter of whether taxpayers had income in 1959 through 1962, against which these losses must be applied first."

The tax returns for the years 1959 through 1965 were stipulated into evidence upon motion of the Respondent.

5. BASIS FOR FEDERAL JURISDICTION IN COURT OF FIRST INSTANCE.

Title 26 U.S.C. Section 7442 provides for the jurisdiction of the U.S. Tax Court with respect to this matter. Title 26 U.S.C. Section 7482 provides for the jurisdiction of the U.S. Courts of Appeals to review decisions of the U.S. Tax Court.

6. ARGUMENT.

We believe that the Writ of Certiorari should be granted. This case represents the first time that an Appellate Court has considered the issues of what is the taxpayer's burden of proof to establish a right to a net operating loss and whether unaudited tax returns stipulated into evidence are sufficient to carry that burden of proof. Further, we believe, that these issues should be settled by this Court so as to eliminate the possibility of future determinations by the courts below in a manner that departs from the accepted and usual course of judicial proceedings; namely, that in the

absence of a determination by the Commissioner of a deficiency, the taypayer has *no burden* to prove duly filed tax returns.

The holding of the U.S. Tax Court below which was affirmed by the second opinion of the U.S. Court of Appeals for the Fourth Circuit, appears to be predicated upon the case of *A. Raymond Jones,* 25 T. C. 1100 (1956), rev'd on another issue, 25 F.2d 300 (5th Cir., 1958). The case of *A. Raymond Jones, supra,* dealt with a net operating loss deduction for the year 1948 based on a net operating loss carry-over from 1947. The Court, in that case, held that the taxpayers had failed to prove their 1945 and 1946 figures because the Commissioner did not accept the figures, but *upon audit,* determined deficiencies for 1945 and 1946. Obviously, returns that were audited and found deficient were, as the Court held in *A. Raymond Jones, supra,* inadequate to sustain petitioner's burden of proof.

In the instant case, the facts are clearly distinguishable from the facts of *A. Raymond Jones, supra.* Here, the Commissioner made no determination of the correctness of the income tax returns for the years 1959 through 1962 and clearly determined no deficiency for any of those years. Moreover, the tax returns involved in the instant case were stipulated into evidence upon the motion of the Commissioner. The instant case would have been anologous to the *A. Raymond Jones, supra,* if the Commissioner had audited the returns and found deficiencies in the years 1959 through 1962.

Furthermore, the instant case presents an issue that this Court should settle. That issue is whether a taxpayer has any burden of proof with respect to an unaudited tax return that has not been determined to be deficient by the Commissioner. If the holding of the U.S. Court

of Appeals for the Fourth Circuit in this case is sustained, it suggests that the Commissioner has no obligation to audit a return and determine whether any deficency exists, but he may merely allege that the return is inadequate and accomplish the same result as if he had audited and found a deficiency.

This issue deals squarely with whether an income tax return filed by a taxpayer is deemed, *prime facie* to be correct. The law, as enacted by the U.S. Congress, is silent on this issue (although the law does provide under 26 U.S.C. Section 6020 that if a tax return is prepared for a taxpayer by the Commissioner under such provision, the burden of proof of any difference in such tax return shifts to the taxpayer). A search of the entire provisions of the Internal Revenue Code of 1954 as amended (Title 26 U.S.C.), and the cases decided thereunder, reveals no holding that, in the computation of a net operating loss carry-back and/or carryforward (in the absence of a determination of a deficiency for any year by the Commissioner), the burden of proof of the accuracy of tax returns is that of the taxpayer.

Accordingly, an important question of Federal Law is this issue of whether tax returns are acceptable, on their face, in the absence of a determination of a deficiency in such returns by the Commissioner, (no less stipulation into evidence upon the motion of the Commissioner). This issue should be settled by this court.

CONCLUSION

We believe that this Court should grant certiorari to hear this case as it involves the basic right of a U.S. taxpayer to utilize his duly filed tax returns as proof of income or loss for the year involved unless the Commissioner determines a deficiency. Further, we believe that this Court should hear this case as the issue of credibility of duly filed tax returns, unaudited by the Commissioner, has not been previously been ruled upon by this Court.

Respectfully submitted,

/s/ SYLMAN I. EUZENT
Sylman I. Euzent

Counsel for Petitioners

APPENDIX A

§ 172. Net operating loss deduction.

(a) Deduction allowed. There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating loss carrybacks and carryovers.

(1) Years to which loss may be carried.

(A) (i)Except as provided in clause (ii) and in subparagraphs (D), (E), (F), and (G), a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.

(B) Except as provided in subparagraphs (C), (D) and (E) a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

* * *

(2) Amount of carrybacks and carryovers. Except as provided in subsections (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction —

(i) without regard to the net operating loss for the loss year or for any taxable year thereafter, and

(ii) without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under paragraph (1)(D), be carried back to such prior taxable year,

and the taxable income so computed shall not be considered to be less than zero. For purposes of this paragraph, if a portion of the net operating loss for the loss year is attributable to a foreign expropriation loss to which paragraph (1)(D) applies, such portion shall be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss, and, if a portion of a foreign expropriation loss for the loss year is attributable to a Cuban expropriation loss, such portion shall be considered to be a separate foreign expropriation loss for such year to be applied after the portion of such foreign expropriation loss.

* * *

(E) Paragraph (1)(E) shall apply only if —

(i) the amount of the taxpayer's net operating loss for the taxable year exceeds the sum of the taxable income (computed as provided in paragraph (2)) for each of the 3 preceding taxaable years of the taxpayer,

(ii) the amount of the taxpayer's net operating loss for the taxable year, increased by the amount of the taxpayer's net operating loss for the preceding taxable year or decreased by the amount of the taxpayer's taxable income for such preceding year, exceeds 15 percent of the sum of the money and other property (in an amount equal to its adjusted basis for determin-

ing gain) of the taxpayer, determined as of the close of the taxable year of such loss without regard to any refund or credit of any overpayment of tax to which the taxpayer may be entitled under paragraph (1)(E),

(iii) the aggregate unadjusted basis of property described in section 1231(b)(1) (without regard to any holding period therein provided), the basis for which was determined under section 1012, which was acquired by the taxpayer during the period beginning with the first day of its fifth taxable year preceding the taxable year of such loss and ending with the last day of the taxable year of such loss, equals or exceeds the aggregate adjusted basis of property of such description of the taxpayer on, and determined as of, the first day of the fifth preceding taxable year, and

(iv) the taxpayer derived 50 percent or more of its gross receipts (other than gross receipts derived from the conduct of a lending or finance business), for the taxable year of such loss and for each of its 5 preceding taxable years, from the manufacture and production of units within the same single class of products, and 3 or fewer United States persons (including as one person an affiliated group as defined in section 1504(a)) other than the taxpayer manufactured and produced in the United States, in the calendar year ending in or with the taxable year of such loss, 85 percent or more of the total number of all units within such class of products manufactured and produced in the United States in such calendar year.

(F) For purposes of subparagraph (E)(iv) —

(i) the term "class of products" means any of the categories designated and numbered as a

"class of products" in the 1963 Census of Manufacturers compiled and published by the Secretary of Commerce under title 13 of the United States Code, and

(ii) information compiled or published by the Secretary of Commerce, as part of or in connection with the Statistical Abstract of the United States or the census of manufacturers, regarding the number of units of a class of products manufactured and produced in the United States during a calendar year, or, if such information should not be available, information so compiled or published regarding the number of such units shipped or sold by such manufacturers during a calendar year, shall constitute prima facie evidence of the total number of all units of such class of products manufactured and produced in the United States in such calendar year.

(c) Net operating loss defined. For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications. The modifications referred to in this section are as follows:

(1) Net operating loss deduction. No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations. In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provide by section 1202 shall not be allowed.

(3) Deduction for personal exemptions. No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayer other than corporations. In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade of business,

shall be treated as attributable to the trade or business,

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction allowable under section 165 (c)(3) (relating to casualty losses) shall not be taken into account; and

(D) any deduction allowed under section 404 or section 405(c) to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

(5) Special deductions for corporations. No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of deduction for dividends received, etc. The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a)(1)(B) of such section.

(e) Law applicable to computations. In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

* * *

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 79-1807

MARGARET E. JOHNSON MALMSTEDT, *Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Appellee.*

No. 79-1808

ESTATE OF BERTIL MALMSTEDT, DECEASED, THROUGH MARGARET E. JOHNSON MALMSTEDT, PERSONAL REPRESENTATIVE, *Appellant,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Appellee.*

Appeal from the United States Tax Court

Argued November 12, 1980
Decided March 26, 1981

Before HAYNSWORTH, Chief Judge, INGRAHAM* Senior Circuit Judge, and MURNAGHAN, Circuit Judge

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* Honorable Joe M. Ingraham, Senior Circuit Judge from the Fifth Circuit, sitting by designation

Sylman I. Euzent for Appellants; Stephen Gray, Tax Division, Dept. of Justice (M. Carr Ferguson, Assistant Attorney General Michael L. Paup, William S. Estabrook, Tax Division, Dept. of Justice on brief) for Appellee.

PER CURIAM:

Taxpayers operated a real estate development business until 1964, when their failure to obtain financing for the Gold Mine hotel project resulted in the termination of the business. The Commissioner assessed deficiencies against taxpayer Johnson for the years 1964, 1965 and 1966, and against taxpayer Malmstedt for the years 1963, 1965 and 1966. The Tax Court affirmed, with certain modifications, the conclusions of the Commissioner. 35 T.C.M. (CCH) 199 (1976).

On appeal, this court reversed in part and remanded. *Malmstedt* v. *Commissioner,* 578 F.2d 520 (4th Cir. 1978). The court concluded that certain expenses related to the development of the Gold Mine venture, which the Tax Court had required the taxpayers to capitalize, should have been deducted as I.R.C. § 162 business expenses. The court remanded for a recomputation of the taxpayers' tax liability, noting that the allocation of these deductions among the tax years in question and the taxpayers' right to carry-forward any of these deductions could only be determined on remand. The Commissioner attacked the Tax Court's determination of Johnson's basis in the real estate business stock, but the court was unable to review this decision on the record before it. Accordingly, the court asked the Tax Court for an explanation of this finding.

On remand, the Tax Court concluded that certain amounts which had been included in Johnson's basis should have been excluded. It reduced her basis from $82,062.83 to $41,262.32. The Tax Court also allowed the Commissioner to amend his answer to the complaint, and ruled, on the basis of this amendment, that the taxpayers had received income resulting from their release in 1965 from a deficiency judgment entered after the second foreclosure sale of the Gold Mine property. The Tax Court permitted the amendment

because this court's opinion had increased the practical importance of the cancellation of indebtedness income and the taxpayers were not surprised by the Commissioner's claim regarding this income. Finally, the Tax Court held that taxpayers were not entitled to a net operating loss carry-forward deduction in 1964, 1965 and 1966 because the taxpayers had proved neither the amount of their losses in tax years 1959 through 1963, nor the amount of their taxable income for any year to which such a loss could be carried. The only evidence on these points was the taxpayers' income tax returns for tax years 1959 through 1965, which the court deemed insufficient to carry the taxpayers' burden of proof, largely because of the demonstrated inaccuracy of other returns filed by the taxpayers.

Malmstedt argues here, as he did below, that he is not bound by this court's prior opinion or by the Tax Court's decision on remand. He relies on his failure to file briefs or participate in oral argument in the prior appeal, even though he filed a notice of appeal. Absent a dismissal, either voluntary or involuntary, of his appeal, Malmstedt's rights and liability are governed by these decisions.

The taxpayers jointly urge that the Tax Court exceeded its jurisdiction on remand by reducing Johnson's basis and by allowing the Commissioner to amend his answer and obtain an increased deficiency. They essentially argue that the Tax Court's mandate on remand was limited to a mere explanation of its determination of Johnson's basis and the recomputation of taxpayers' tax liability in light of this court's decision.

We decline to read our prior opinion so narrowly and conclude that the Tax Court properly proceeded on remand to adjudicate issues not specifically resolved on appeal. Nor do we believe that this court's prior determination that certain expenses were deductible foreclosed inquiry into the matter of whether taxpayers had income in 1959 through 1962 against which these losses must be applied first.

We find the other contentions raised by the taxpayers similarly unpersuasive.

AFFIRMED.

APPENDIX C

Margaret E. Johnson Malmstedt, et al., Petitioner v. Commissioner of Internal Revenue, Respondent.

Docket No. 4647-71, 4649-71. Memorandum Sur Order. Filed April 10, 1979. Reconsideration of 35 TCM 199, Dec. 33,674(M), T. C. Memo. 1976-392, on remand from CA-4, 78-2 USTC ¶ 9479, 578 F. 2d520. [Appealable, barring stipulation to the contrary, to CA-4. — CCH.]

[Code Sec. 165]

Losses: Stock: Worthlessness: Basis — The basis of stock on the date it became worthless was redetermined on remand. An addition to basis for an estimated increase in the value of land was disallowed, as were amounts attributable to accounts payable where it could not be determined if the liabilities were assumed by the corporation — CCH.

[Code Sec. 6214]

Deficiency: Increased determination: Commissioner's motion to amend answer. — The Commissioner was allowed to amend his answer to include an increased deficiency due to income attributable to a release from a deficiency judgment entered after a judicial sale. Although the motion was not filed until after the appeal, the request was timely because the individuals had ample opportunity to answer the Commissioner's claim. — CCH.

[Code Sec. 172]

Net operating loss: Carryforward: Burden of proof: Preparatory real estate development expenditures. — Claimed net operating loss carryforward deductions were disallowed. The individuals failed to prove the amount of loss for any of the years or the amount of taxable income for any year to which such losses could be carried. — CCH.

Memorandum Sur Order

STERRETT, Judge: On January 8, 1979 respondent filed a Motion for Leave to File Amendment to Answer, and Amendment to Answer for each of docket Nos. 4647-71 and 4649-71. Also on January 8, 1979 respondent filed

Respondent's Memorandum on Remand with Computations. Respondent's Memorandum on Remand raised three issues:

1. The basis for our finding that Johnson had an $82,062.32 basis in her Construction Company stock (respondent included certain figures representing his beliefs with respect to the source of our finding);

2. Whether Johnson and Malmstedt had income due to their release from a deficiency judgment entered after the second judicial sale of the Gold Mine Property. Respondent's proposed amendments to answer would increase the claimed deficiencies in issue to reflect this added foreclosure income; and

3. Whether the current deductions allowed the partners by the Fourth Circuit's opinion for their interest and tax expenses and for their amortization of a loan refinancing fee should create net operating loss carryforward deductions in 1964, 1965 and 1966.

On January 10, 1979, petitioners filed a motion asking that we allow Johnson net operating loss carryforward deductions in 1964, 1965 and 1966, and describing petitioners' beliefs with respect to the source of our determination that Johnson's basis in her Construction Company stock was $82,062.32. Also on January 10, 1979, petitioners each filed an Opposition to Motion for Leave to File Amendment to Answer. A hearing on remand was held on January 10, 1979.

The first issue with which we must deal relates to our determination that petitioner Johnson had an $82,062.32 basis in her Construction Company stock when that stock became worthless in 1964. The parties are in agreement with respect to how they think we derived that basis for Johnson. Although the parties are correct in their assumptions with respect to the origin of our determination, we believe, upon reconsideration of the evidence, that we too uncritically accepted petitioner Johnson's averments with respect to her Construction Company stock basis. In deriving the $82,062.32 basis we simply took at face value petitioner Johnson's own calculations on that point.

Eighty-two thousand sixty-two dollars and thirty-two cents is the sum of $38,409.06, representing Johnson's capital account as shown on Construction Company's books, $35,853.26 representing Johnson's one-half interest in an account under the names of both Malmstedt and Johnson, and $7,800 representing Johnson's one-half interest in certain accounts payable. We erred in two respects. First, Johnson's capital account of $38,409.06 included an amount of $33,000 which she simply had added to that account as her estimate of the increase in value of two separate tracts of land when the partnership combined them into one tract. We now hold that we were in error in permitting her to carry over said amount since she had no basis in that claimed increment in value. Secondly, we included in her stock basis amounts attributable to the above mentioned accounts payable. As we cannot tell from the record whether or not these notes were assumed by the corporation, we shall simply exclude them from consideration in determining Johnson's stock basis. Thus they shall neither increase nor reduce her basis in her Construction Company stock. See section 358 (a)(1)(A)(ii), and subsection (d). Johnson's correct basis in her Construction Company stock is thus: ($38,409.06 — $33,000) + $35,853.26 = $41,262.32.

The next issue with which we must deal involves respondent's motions to amend his answer to claim an increased deficiency. These motions were filed on January 8, 1979 over 7 years after the original answers were filed in September 1971. The applicable code sections are sections 6214(a) and 7453. Section 6214(a) says:

SEC. 6214. DETERMINATION BY TAX COURT.

(a) Jurisdiction as to Increase of Deficiency, Additional Amounts, or Additions to the Tax. — Except as provided by section 7463, the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or addition to the tax

should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or a rehearing.

Section 7453 says in relevant part:

[T]he proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe * * *.

Rule 41(a), Tax Court Rules of Practice and Procedure, says in material part:

Otherwise a party may amend his pleading only by leave of court or by written consent of the adverse party; and leave shall be given freely when justice so requires * * *.

In deciding whether to grant respondent's motion we face, therefore, two questions: Is respondent's motion such as is contemplated by section 6214(a), and if so, does justice require that we allow respondent's motion at this time? Respondent's motion will be "timely" within the meaning of section 6214(a) if it is filed before a "rehearing." In the case of *Boeing* v. *Commissioner,* 47 B. T. A. 5 (1942), we defined "rehearing" in appellate practice to be " 'a second consideration on further argument, given to a cause after decision.' " *Boeing* v. *Commissioner, supra* at 8. We believe that the hearing held herein on January 10, 1979 qualifies as a "rehearing" within the meaning of section 6214(a), and *Boeing* v. *Commissioner, supra.* At that time we heard the parties present their arguments with respect to respondent's motions to amend. Also at that time both parties argued the merits of their views with respect to how this Court should deal with the issues raised by the Fourth Circuit's remand. As respondent's motion was made, therefore, before a rehearing, we find that it was timely.

We believe that our view of the matter comports with that which would be adopted by the Fourth Circuit herein.

The case of *Helvering* v. *Edison Securities Corporation* [35-2 USTC ¶ 9425], 78 F.2d 85 (4th Cir. 1935), reversing [Dec. 8310] 29 B. T. A. 483 (1933), originated before the Board. We had decided one issue based on a theory not argued by either party. *Helvering* v. *Edison Securities Corporation,* 78 F. 2d at 90. Our decision created an increased deficiency but we refused to entertain respondent's motion to increase deficiency on the basis that his motion was untimely. The Fourth Circuit reversed and remanded saying (78 F. 2d at 91):

> [A] claim of increase may be made and considered with propriety, whether it is presented during the taking of the evidence or in the period allowed for oral arguments, or written briefs, or even subsequently during the hearing under Rule 50, in short, at any time before or after the filing of the Board's findings of fact until the decision and judgment of the Board has been entered; or even later, in the event of a rehearing.

In the case of *Henningsen* v. *Commissioner* [57-1 USTC ¶ 9637], 243 F. 2d 954 (4th Cir. 1957), the commissioner had included a certain item of income in the taxpayer's taxable year 1946. In his opening statement at the trial before the Tax Court the taxpayer declared that he would show that this income was includable in his 1947 taxable year. In response the government's counsel requested in his opening statement that he be allowed to amend his answer to claim an increased deficiency for 1947 if petitioner should actually be able to show that the income at issue was attributable to 1947. Petitioner carried his burden on this point and we granted respondent's motion to amend. His amendment was filed almost one month after the trial. The Fourth Circuit affirmed the propriety of our action saying at 959:

> We have held there is no reason why the word "hearing" should not be given a significance broad enough to include the whole proceeding down to the final decision, since the purpose of the statute is to give the taxpayer an opportunity to answer and resist the claim before it is made effective by action of the court; and that if this is

> done a claim of increase is made in time whether it is presented during the taking of the evidence or in the period allowed for argument or briefs, or even subsequently during the hearing under Rule 50 * * * ; in short, at any time before the decision and judgment of the court have been entered.

In the case of *Commissioner* v. *Ray* [37-1 USTC ¶ 9108], 88 F. 2d 891 (7th Cir. 1937), revg. a Memorandum Opinion of this Court [Dec. 9122], the Seventh Circuit took a similar position. In that case petitioner's taxable years 1926 and 1928 were before the appeals court. Respondent had originally claimed a deficiency for petitioner's taxable year 1926 based on a theory that would have allocated certain income to that year. We decided the case according to a theory under which petitioner realized the income in 1928 — yet we had also denied respondent's motion to amend his answer to claim an increased deficiency for 1928. The Seventh Circuit reversed saying at 892:

> There is no reason why the Board should not be as liberal in allowing amendments to claims as courts are in allowing amendments to pleadings. The statute fixes the time limit within which the claim may be asserted, — "at or before the hearing or a rehearing." The Commissioner was within the time thus fixed.

The court went on to note that the commissioner had made no new or different claim, that respondent had always asserted that the amount in issue was income and that petitioner had met this assertion squarely.

The case now before us is similar to those before the Fourth and Seventh Circuits in *Helvering* v. *Edison Securities Corporation,* 78 F. 2d at 85, *Henningsen* v. *Commissioner, supra,* and *Commissioner* v. *Ray, supra.* We think that, with respect to the issues discussed in this Memorandum Sur Order, petitioners have had ample opportunity to answer and resist respondent's claims. On that basis we hold that respondent's motion was timely.

Thus we come to the question of whether or not justice requires that we grant respondent's motion to amend his answer. The relevant facts are these: respondent argued his case before us on a theory that all the amounts expended on Gold Mine between 1960 and 1963 were capital expenditures. Petitioners argued that they were all currently deductible. Respondent's theory had the obvious effect of increasing petitioner's basis in the Gold Mine property. Thus, while respondent stated on brief that the second foreclosure on the Gold Mine property generated a $69,881.18 deficiency and judgment and included this amount, when forgiven, in the amount realized by the partnership on the second foreclosure sale, the net effect of this additional amount realized was to produce a total of only $934.79 in long term capital gain or $467.39 to each of Malmstedt and Johnson, unadjusted for section 1202. Yet as had been the case in *Henningsen* v. *Commissioner, supra* and *Commissioner* v. *Ray, supra,* respondent's theory was not fully accepted by either this Court or the Fourth Circuit. This Court found that certain interest expenses, real estate taxes, and a loan refinancing fee, totaling $339,279.73, were currently deductible. We found that the other amounts in issue were capital expenditures. These findings obviously decreased petitioners' Gold Mine basis and increased the importance of the income generated by the debt forgiveness.

Contrary to the apparent understanding of respondent as described in his Memorandum on Remand with Computations, we also found that the second foreclosure sale produced a deficiency of $69,881.18 excluding interest and that: "Properties, Inc. the maker, and the guarantors, Johnson, Construction, Inc, Malmstedt, and Joseph Stroud were released from liability for this deficiency in 1965." Finally we held that any gain or loss on the foreclosure sale, including any gain generated by the deficiency judgment's forgiveness was recognizable only in 1964.

Respondent, however, did not attempt then to amend his answer to claim an increased deficiency even though

Johnson's taxable year 1964 was before us. See *John Gerber Company* v. *commissioner* [Dec. 11,738], 44 B. T. A. 26, 31-32 (1941). Nor did his computation for entry of decision under Rule 155, Tax Court Rules of Practice and Procedure, include any amount in respect to this forgiveness income. Petitioner did not object to this computation and we adopted it as the basis for our decision herein.

On appeal the Fourth Circuit agreed that a deficiency judgment in the amount of $69,881.18 had been entered against the partners in respect of the second Gold Mine foreclosure sale from which they were released in 1965. The circuit court did not disturb our determination that all income on the foreclosure *sale* was recognizable in 1964. The Fourth Circuit's judgment was filed with us on July 24, 1978. Respondent, apparently concluding that the Fourth Circuit's opinion had held the deficiency judgment forgiveness to be a taxable event, while our opinion had not, filed the two motions for leave to answer and the two amendments to answer referred to above. These amendments claim increase deficiencies in either 1964 and 1965 based on this foreclosure gain.

In his response to respondent's motion petitioner Malmstedt (docket No. 4649-71) argued that he is not properly before us and that respondent's motion to amend is "illegal" with respect to him because "neither party filed any Notice of Appeal * * * [and] no appeal was heard with respect to the merits of the case Bertil Malmstedt v. Commissioner of Internal Revenue." Therefore, Malmstedt concludes that his case is final. Section 7481. As petitioner Malmstedt filed his notice of appeal with this Court on January 5, 1977 followed by respondent's cross notice of appeal on January 26, 1977, and since no dismissal thereof has been entered, we find that he is still before this Court.

Petitioner Johnson's argument that our decision is final with respect to the foreclosure income issue alone — as opposed to the rest of the case — is creative. We find no evidence in the record that this issue was severed or somehow matured into finality while the rest of the case has not.

Given the state of the record and these above described events we do not believe that petitioners can legitimately argue surprise at respondent's motion. They have long been appriseed or respondent's belief that the foreclosure debt forgiveness generated income. At the hearing herein and by their memoranda both petitioners had ample opportunity to argue the merits of respondent's motion. While it is unfortunate that respondent did not file his motion before this case was appealed to the Fourth Circuit, we conclude that it is in the interest of justice to allow respondent to correct his oversight now. See *Helvering* v. *Edison Securities Corp., supra, Commissioner* v. *Ray, supra.*

Next we address the issues of the timing and character of the deficiency forgiveness income. Firstly, we do not believe that our finding, that the gain from the foreclosure *sale* can only be recognized in 1964, should be interpreted as our conclusion on the timing of the deficiency forgiveness income. While it is clear that the deficiency judgment arose in the foreclosure proceedings, we think it equally clear that the forgiveness thereof was the independent volitional act of a third party. This forgiveness income is something more than merely additional "sale" proceeds. We conclude that petitioners received cancellation of indebtedness income in 1965 when the debt was cancelled. Further we conclude that this income was long term capital gain. Had the foreclosure transaction generated a loss, such a loss would have been deductible to the partnership as long term capital loss. See *Diamond* v. *Commissioner* [Dec. 11,690], 43 B. T. A. 809, 812 (1941). Had the deficiency been discharged in 1964 it would have been additional long term capital gain. See *R. O'Dell & Sons* v. *Commissioner* [48-2 USTC ¶ 9350], 169 F. 2d 247, 248 (3rd Cir. 1948). The delay should not cause a change in the character of the income. See *Arrowsmith* v. *Commissioner* [52-2 USTC ¶ 9527], 344 U.S. 6 (1952).

Finally we deal with petitioners' claim of net operating loss carryforward deductions in 1964, 1965 and 1966 due to alleged losses incurred in their taxable years ended December

31, 1960 through 1963. This is not the first time we have seen this claim. Petitioners argued it when this case was first before us. It is based on their claim of a right to currently deduct the same $528,664.19 Gold Mine start up cost at issue in determining the Gold Mine basis described to above. As mentioned above, respondent argued that these expenditures were entirely capital while petitioners claimed that they were currently deductible in full. In our opinion herein we held that the $150,000 loan refinancing fee was amortizable over the life of the loan refinanced, and allowed the current deduction of certain real estate taxes and interest expenses. We found that the rest of the partnership outlays were capitalizable. We did not however allow petitioners their claimed net operating loss carryforward deductions.

We based our disallowance on three points. We held: (1) that petitioners had neither proven the amount of loss for any of the years 1960 through 1963 nor the amount of taxable income for any year to which such losses could be carried. This was so because the only evidence offered by petitioners to sustain their claim was their own income tax returns for their taxable years 1959 through 1965. We had and still have grave doubt as to these returns' accuracy. We held that these returns were insufficient to sustain petitioners' burden of proof on this issue. (2) We doubted:

> [W]hether there exists any net operation losses for petitioners to demonstrate. Their alleged losses are predicated upon the $528,664.19 of expenditures incurred to develop Gold Mine. However, we have held many of these expenditures to be nondeductible and as such they cannot enter into the computation of a net-operating loss. Section 172(c). (T.C. Memo. 1976-46 at 29.)

(3)Finally we held that petitioner's losses, if any, were not incurred in a trade or business and were, therefore, subject to the limitations of section 172(d)(4).

The Fourth Circuit remanded this case because it did not agree with our third reason for disallowing net operating loss

deductions to petitioners. Our first two reasons remain unaffected by the Circuit Court's opinion. If anything, our first two reasons were strengthened inasmuch as the Fourth Circuit agreed with our conclusion that part of the expenditures incurred to develop Gold Mine were capital in nature.

On motion and at the hearing herein petitioners once again pressed for the same net operating loss carryover deductions we disallowed originally. At the hearing herein petitioners indicated that they still could produce no evidence other than the returns we have already seen and rejected. Petitioners have still failed to carry their burden on this point. We hold for respondent.

We note in passing that the Fourth Circuit agreed with our holding that the $150,000 refinancing fee paid by petitioners when they refinanced their Gold Mine indebtedness was amortizable over the life of the loan refinanced. The note thereon was due January 18, 1963, one year after execution. It was extended to May 18, 1963. Thus the refinancing fee must be amortized on the basis of the number of days between January 18, 1962 and January 18, 1963. Any amount remaining for amortization after 1962 must be amortized over the number of days between January 1, 1963 and May 18, 1963.

Therefore it is

ORDERED that respondent's Motions for Leave to File Amendment to Answer are granted. It is further

ORDERED that petitioners' motion to adopt computation, filed January 10, 1979 are denied. It is further

ORDERED that decisions will be entered in accordance with the computations shown in Appendixes A-1 and B-1 of Respondent's Memorandum on Remand with Compulsions.